

ELIGIBILITY REPORT
SECOND DISBURSEMENT
FINANCIAL SECTOR REFORM PROGRAM II
Loan 1400/OC-GU

Amount of Loan: US\$200 million
Date of Contract: September 17, 2002
Amount of First Tranche: US\$120 million
Date of First Tranche Disbursement: September 26, 2002
Amount of Second Tranche: US\$80 million

I. Background

- 1.1 The purpose of this report is to present the actions taken by the government of Guatemala in the execution of the Financial Sector Reform Program II, which is supported by Loan 1400/OC-GU. To evaluate these actions the Bank has reviewed the documents that the Government of Guatemala has delivered to the Bank and had detailed discussions with the authorities about these documents, the actions that they have taken and the compliance of the conditions. References are made in Section III to the Annexes in the technical files of the Bank that contain these documents.
- 1.2 With the actions that they have taken, the Government has complied with the special contractual conditions for the second disbursement set out in Article 4.04, letters (a) through (m) except for letters (c) and (f). Substantial progress has been made towards complying with clauses 4.04 (c) and 4.04 (f). However, as explained in Section III, some additional steps need to be taken to fully comply with these conditions. Accordingly, the Government of Guatemala, in a letter dated February 18, 2004, has requested a waiver of these two conditions. The Administration recommends that the Board of Executive Directors approve these waivers, based on the explanations provided below.

II. Frame of Reference

- 2.1 Loan 1400/OC-GU was approved by the Bank on May 22, 2002. The loan contract was signed and came into effect on September 17, 2002. The objective of the Program was to modernize the legal framework of the financial sector and to strengthen the Bank of Guatemala (Banguat) and the Superintendency of Banks (the Super). To achieve its objectives the Program supported a series of legal reforms, the issuance of regulations that are required by the legal reforms and the implementation of action plans to enable the authorities to execute the reforms.

The Program was executed by the Government of Guatemala with the participation of the Ministry of Public Finance, the Central Bank and the Superintendency of Banks. In parallel, the Bank prepared a technical cooperation program with the Superintendency of Banks and Guatemala entered into a macroeconomic stabilization program, which was monitored by the International Monetary Fund.

- 2.2 The Program has been successfully implemented by the Government of Guatemala. At the beginning of the Program, a banking crisis threatened Guatemala. Six banks required lender of last resort (LOLR) support from Banguat, as a result of a combination of external shocks, bad management, abuses and an inability of the Superintendency to control these problems. This inability derived from deficiencies in the law, which did not give the authorities the powers necessary to require corrective actions. The new legal framework was passed in mid-2002 and the authorities were able then to contain the problem. Three of the banks repaid their LOLR advances and the other three were intervened and are in the process of being liquidated. Since then, the extremely weak economic situation that characterized the last few years has meant that it has not been easy for the banks to grow out of their problems. In spite of this, the Superintendency and the Monetary Board have been able to prevent these problems from recurring. In addition, although it was not a requirement of the Program, it should be noted that Guatemala has passed into law a strong anti-money laundering act on November 28, 2001. This act has been regulated and is fully in effect. It is being implemented in a technical unit that is part of the Superintendency. This unit has been actively pursuing many cases of money laundering and it is believed that these efforts will result in Guatemala being removed from the GAFI black list in June 2004.

III. Analysis of the Compliance of the Special Conditions for the Eligibility of the Second Disbursement.

Conditions Related to the Macroeconomic Program

- 3.1 **Article 4.04 (a)** That the macroeconomic stabilization program mentioned in paragraph (a) of Article 4.03 of these Special Conditions is being implemented satisfactorily. **(complied)**
- 3.2 In April of 2002 the Government of Guatemala entered into a Stand-By Agreement with the International Monetary Fund. In this agreement, the IMF monitored the macroeconomic program of the Government. (Annex 1 contains the Government's macroeconomic program for 2003 and 2004, along with an indication of the macroeconomic goals that were met in the 2003 program.) The agreement was for a 12-month period and was in the amount of SDR 84 millions. This macroeconomic program was successfully implemented and, as a result the economy grew by 2.2% in 2002 and inflation fell to around 6%, and international reserves grew. The fiscal deficit fell to less than one percent of GDP, as a consequence of restrictions on government spending and an increase in tax revenues. It is important to mention that the consolidated public sector deficit

- 0.8% of GDP, which included the losses of the Bank of Guatemala, was reduced more than the goal of 1.5% that the macroeconomic program set.
- 3.3 In June of 2003 the Government entered into a second agreement with the IMF, this time for nine months, in order to have the benefit of a continuation of the monitoring of their macroeconomic program. This agreement expires on March 15, 2004. The macroeconomic program was designed to consolidate the macroeconomic stability following the elections that would be held in November 2003 and to continue the progress of certain key structural reforms. An additional objective of the program was to accommodate additional government spending related to the Peace Accords, including an increase in spending on social services. Another objective was to reduce inflation even more and to continue increasing international reserves. Structural goals included new steps related to financial sector reform and various measures to improve the transparency of the public administration.
- 3.4 Economic performance under the 2003 program was satisfactory, as demonstrated by most available indicators of economic activity. The targets for economic growth, inflation, and the external and fiscal balances were broadly achieved, in some cases with margin. Real GDP growth remained at just over 2 percent, as assumed in the program. Inflation declined to 5.85 percent year-on-year at the end of 2003, which was within the target range of 4-6 percent.
- 3.5 Net international reserves increased by US\$521 million to US\$2799 million (4.6 months of next year imports of goods and services), well above the US\$2,528 million contemplated in the program. The external current account deficit, which had declined from 5.9 percent of GDP in 2001 to 5.1 percent in 2002, narrowed further to 4.5 percent of GDP in 2003. The current account deficit performance again was significantly better than the 5.5 percent of GDP contemplated in the program for 2003, as workers remittances grew faster while imports increased more slowly than expected.
- 3.6 A main challenge for the authorities in 2003 was to resist pressures to increase the fiscal deficit in the run-up for the elections. In December 2002 the Constitutional Court declared the gasoline distribution tax unconstitutional on technical grounds, but the government moved swiftly to compensate for the revenue loss by raising import tariffs temporarily, and then secured congressional approval in February 2003 to reinstate the tax with the appropriate corrections. In March, teachers and other groups mounted a nationwide strike to press for higher wages and other increases in public spending, but the authorities again resisted these pressures. As of September 2003, most quantitative fiscal performance criteria had been met, including the combined public sector deficit. For the whole of 2003, according to preliminary figures from the authorities, the central government deficit increased to 1.8% of GDP, slightly exceeding the target of 1.6% of GDP. Preliminary information also suggests that the combined public sector deficit has exceeded the 1.7% of GDP target, but again by a relatively small margin.
- 3.7 Banguat continued to apply a tight monetary policy in 2003, helping to limit growth in the currency issue to 8.8 percent. After a 2 percentage point fall in

- 2002, nominal bank lending interest rates fell by another 2 percentage points, to 14 percent, reflecting weak growth of private demand for bank credit (4.4 percent) and stable or falling inflation. The exchange rate continued to float without any significant official intervention, resulting in a quetzal depreciation of 3% vis-à-vis the US dollar, and in a real effective appreciation of about 1%.
- 3.8 The new administration, which took office in January 2004, has inherited a relatively stable macroeconomic situation. However, the new authorities are also faced with medium term and some pressing immediate issues, principally regarding the fiscal situation. First, the progress towards increasing the tax ratio towards 12 percent of GDP, as required by the Peace Agreement, has stalled in 2003, with a tax ratio decreasing slightly from 10.7 to 10.4 percent of GDP. In addition, the decision in December 2003 by the Constitutional Court to eliminate the tax on sales or assets (IEMA) as of January 2004 means that the government must find other resources to compensate for the shortfall.
- 3.9 The new authorities are working to address these issues, particularly the shortfall in tax revenues caused by the elimination of the IEMA. One alternative would be to increase existing taxes. Another would be to pass an emergency temporary measure while a more permanent solution is crafted. Once they have decided how to handle the problem of revenues, the authorities will develop a broader dialogue with the IMF and the other major MDBs. They have already announced the decision to re-launch the Fiscal Pact agreed in 2000 by almost every sector of the Guatemalan society, which implementation had been set aside in the last few years. The Fiscal Pact framework is particularly appropriate for addressing not only the revenue issues but also the expenditure issues as well as many governance and transparency issues, and provides for a long-term vision. As per official public statements, all of these aspects are prominent part of the new administration's agenda.

Conditions Related to the Reforms of the Central Bank

- 3.10 **Article 4.04 (b)** That the Organic Law of the Bank of Guatemala, the Monetary Act and the Free Negotiation of Foreign Exchange Act have come into effect and the regulations are being applied in a manner which, among other aspects, insures the independence of the Bank of Guatemala in the execution of the monetary, exchange and credit policies. **(complied)**
- 3.11 The Free Negotiation of Foreign Exchange Act was passed into law in December, 2000 and came into effect in May 2001. The other two laws were approved by Congress on April 2002 and came into effect on June 2002. (Annex 2 contains the texts of the laws, their respective white papers and their regulations.) This reform was implemented because the earlier legal framework (50 years old) tied the hands of the authorities in several ways that weakened the ability of the Banguat to perform its functions. Weaknesses in the lender of last resort provisions had disfigured the bank resolution framework by practically obliging Banguat to keep insolvent banks alive. A lack of a clearly stated objective for the central bank meant that its efforts were diluted between the conflicting goals of providing easy credit and creating the conditions for low inflation and

macroeconomic stability. And the institution was not independent. The president and vice-president were appointed by the President of the Republic and could be and were removed with each change in government. This lack of independence led to a marked instability in monetary, credit and foreign exchange policy. Compliance with this condition has been evaluated on the basis of a reading of the above-mentioned laws, by an analysis of the actions taken by Banguat in the period following the enactment of the new legal framework and in observed changes in the way that Banguat has executed policy over the two years following the passing of the new laws.

- 3.12 The new Bank of Guatemala Act does three things to increase the independence of the central bank. It provides stability to the senior management of the central bank. Secondly, the new law contains the clearly stated goal of promoting monetary stability. Third the new law mandates the creation of a Policy Execution Committee comprised of selected technical staff of Banguat.
- 3.13 The new LOLR powers of Banguat are limited to providing temporary liquidity. These liquidity advances are for a period of 30 days, renewable for one additional 15 days. The rate of interest of the advances must be higher than the average lending rate of the bank receiving the assistance, creating a disincentive for abusing access to the LOLR window. Furthermore, the Super must inform the MB of the need for LOLR financing, providing a reasoned justification, which has the effect of creating an additional filter.
- 3.14 In the new law the senior management of Banguat enjoy more stability in the exercise of their functions. They cannot be removed from office arbitrarily, but rather through a process that discourages a capricious change of management. Furthermore, the periods of office of the president and vice president of Banguat run for four years starting in September 2002. This creates a cycle that begins and ends on a date exactly halfway through the period of office of the national government. In this way, there is some isolation of the management from removal at the beginning of a new government. The current president and vice president's terms end on September 2006. The recent change of government in Guatemala provides the first test of this measure. The government has appointed all of the new ministers and the new ambassadors are in the process of being named but the senior (and junior) management of Banguat has stayed the same.
- 3.15 The independence of the central bank was also increased by the statement in the law that the objective of Banguat is to promote price stability. The lack of a clear goal had hindered the development of an independent monetary policy. The earlier Bank of Guatemala Act assigned to Banguat the goal of "promoting the creation and maintenance of monetary, exchange and credit conditions favorable to the orderly development of the economy." Another part of the Act required Banguat to maintain a stable exchange rate. While such goals are laudable, they are imprecise and depart from the more modern tendency of stating a central bank's goal as preserving price stability. The new goal is to preserve price stability and this clear statement has largely eliminated the pressure that existed before to facilitate easy credit conditions, or defend an exchange rate -- things that in the past gave rise to macroeconomic volatility. As discussed above in the

evaluation of the macroeconomy, the situation now is very stable, and has been since the passing of the new legal framework.

- 3.16 Lastly, a Monetary Policy Execution Committee has been established. This committee is meeting regularly to determine what actions to take with regard to the execution of policy. Before these actions tended to be influenced by the Monetary Board, a more political body.
- 3.17 **Article 4.04 (c)** That the Borrower has completed the process of recapitalization of the Bank of Guatemala, in conformance with the mechanism mentioned in paragraph (c) (i) of Article 4.02 of these Special Conditions. **(waiver requested).**
- 3.18 In the past, the execution of monetary policy has caused quasi-fiscal losses to accumulate in Banguat, reaching approximately 8% of GDP. The new Bank of Guatemala Act requires the Super to conduct an audit of Banguat to determine the precise size of the losses. Following this, the Ministry of Public Finance will cover the losses by issuing a non-negotiable bonds and transferring them to Banguat in an amount equal to the losses. These bonds will not bear interest. This solution to the problem has the advantage of covering the accumulated losses without requiring a transfer of resources, which would have required tax increases or cuts in public spending on social services.
- 3.19 The Super has conducted the audit, which revealed a deficit of Quetzales17.7 billion, equivalent to US\$2.2.b, which was consistent with the earlier estimates. Based on this, the Government prepared a law requesting congressional authorization for the issuance of the bond. This was introduced into Congress last year, but it was not passed in the congress that was controlled by the then governing party. (Annex 3 contains the results of the Super's audit, an explanation of the steps the Government has taken to cover the losses and the text of the bill to authorize the issuance of the bonds to cover the losses.) The Government will re-introduce it sometime this year and they are reasonably confident that the bill will pass.
- 3.20 Since the new Bank of Guatemala Act obliges the Ministry to take the actions described above to cover the deficit, since some of these actions have already been taken and since the Ministry has reaffirmed that it will reintroduce the request to Congress, the Administration of the Bank feels that the conditions are present to justify the request for a waiver.

Conditions Related to the Reforms of the Banking System

- 3.21 **Article 4.04 (d)** That the Bank and Financial Groups Act and the Financial Supervision Act have entered into effect and that the regulations of these laws are being applied. **(complied)**
- 3.22 These laws were approved by Congress in April 2002 and came into effect on June 1, 2002. (Annex 4 contains the texts of the laws, their respective white papers and their regulations.) They have been fully regulated (see Annex 4.1) and these regulations are being vigorously applied. Some specific evidence demonstrating that these laws and regulations are being applied is provided in the

analysis of conditions 4.04 (e) through (m). In this section some additional evidence is presented to demonstrate that these laws are being fully applied.

- 3.23 Regulations have been issued by the Monetary Board covering the presentation of financial statements, related party lending, loan classification, bank mergers, required level of capital, deposit insurance, the liquidation of insolvent entities, and many other areas. When institutions are not in compliance with the regulation, fines are levied and collected or corrective actions are enforced. These corrective actions can be extreme, as is evidenced by the closing of two banks, and in increases in capital in many others. The Super is acting energetically in the enforcement of this legislation, which touches the economic interests of bank owners and borrowers. The staff of the Super are as a result subjected to frequent arbitrary lawsuits, the embargo of their assets and worse. This and other evidence, present a clear picture of compliance with the new legal and regulatory framework that was supported by Loan 1400/OC-GU.
- 3.24 **Article 4.04 (e)** That all the banks of the financial system have formed risk management committees, approved by the Superintendency of Banks. **(complied)**
- 3.25 Before the passing of the new legal framework some banks did not control risks in the manner in which a modern bank must in order to protect itself from losses. In particular, loan concentration was high, insider lending was common and the quality of credit analysis was poor. In order to promote a more rigorous risk management culture, the Super issued Circular 1206-2003 that mandates the creation of risk management committees in the banks. The list in Annex 1 shows that all of the banks have established risk management committees. Citibank, a branch of the bank headquartered in New York, has its risk management committees in New York. (Documents in Annex 5 show that all of the banks have risk management committees, and related support material.)
- 3.26 **Article 4.04 (f)** That all the banks of the financial system have prepared and put into operation risk management manuals, verified by the Superintendency of Banks. **(waiver requested)**
- 3.27 The Super requires that the banks manage effectively three kinds of risks: credit risks, liquidity risks and operational risks. It also requires that the banks follow acceptable policies and practices with respect to these three kinds of risks. When the Super has determined that the policies and practices are acceptable, the bank in question publishes them in three manuals, whose contents are approved by the Super.
- 3.27 With the passing of the new legal framework in mid-2002, the Monetary Board, at the request of the Super, issued three regulations covering the management of these three risks. (Documents in Annex 5 show the steps that have been taken to date to comply with this condition.) These regulations specify the kinds of risk management policies and practices the banks must have, and gives them until April 30, 2004 to have them published in the manuals. In the meantime, the Super has been in constant dialog with the banks to measure their progress

towards this goal. They measure progress in the following areas to ensure that the deadline will be met: Policies, procedures and analytical methods; the quality of information analyzed; the managerial controls on the taking of risks; the treatment of credit to related parties; risk concentration; and procedures to make provisions for risks taken. A score is given to each bank. On average the banks have completed 58% of the process towards having their credit risk procedures accepted by the Super, 51% in relation to liquidity risks, and 44% in relation to operational risks. This progress is considered to be consistent with meeting an April 30, 2004 goal. However, as of today, this condition has not been fully complied with and therefore a waiver is requested.

- 3.29 Since the objective of this condition – that the banks be required to carefully manage the risks that they are taking – has been met and since the banks are expected to comply with the regulation in this matter within the time frame that the regulation requires, a waiver of this condition is requested.
- 3.30 **Article 4.04 (g)** That all the banks of the financial system comply with the norms related to risk capital and that those that have not complied with these norms are executing a restructuring programs or have suspended activities, by order of the competent authority. **(complied)**
- 3.31 Regulation JM-179-2002 requires the banks to maintain a level of capital equal to 10% of the weighted average of their risk assets. This is in excess of the requirements of Basle, which equal 8% of risk assets. This regulation is being applied and the banks are in compliance with it. The list in Annex 6 shows the level of risk assets, the required level of capital to cover those risks and the amount of capital each institution actually has. Two banks were unable to meet the required levels of capitalization and these banks have been closed.
- 3.32 **Article 4.04 (h) That** all of the banks of the financial system have been inspected in conformity with the new legal framework, and that as a result of these inspections, the Superintendent of Banks has sanctioned those that were found to be out of compliance with the laws and norms. **(complied)**
- 3.33 All of the banks (and financieras) of the system have been inspected in accordance with the new legal framework. These inspections have identified some instances in which the institutions were not following the law or the regulations. In these cases fines have been levied and/or the institutions have been required to take corrective actions. Annex 7 contains: (i) a list of the sanctions that have been applied against banks, with descriptions and status in each case; (ii) the same for financieras and financial warehouses; (iii) a list giving a description of the adequacy of loan provisions and the actions that individual institutions have taken to meet the provisioning requirements. As of this date, all of the banks are in compliance with their provisioning requirements. Annex 8 also contains information explaining the actions that the banks are taking to meet requirements that the Super is imposing regarding the constitution of other reserves.
- 3.34 **Article 4.04 (i)** That at least seven financial groups, as defined by the law, have been qualified by the Superintendency of Banks and have been subjected to

at least one inspection which applied the principles of consolidated supervision. **(complied)**

- 3.35 Before the reforms banks, offshore banks, finance companies, financial warehouses, insurance companies, and securities companies were all regulated in accordance with separate laws. However, they tended to be grouped together into a number of financial groups. This facilitated the movement of assets between the various companies in the Group. Sometimes the movement of these assets was done to move non-performing loans out of a bank that was going to be inspected by the Super and into its offshore bank. These movements were impossible for the Super to detect because it had no authority to inspect or even to request information regarding the non-bank companies in the group. This problem contributed to the collapse of three institutions in 2001, something that might have been preventable if the new legislation had been in place.
- 3.36 The new legislation creates the figure of a financial group and makes it legal for groups to operate as such, provided that they apply to be recognized by the Super and provided they permit the Super to have full access to all of the activities that are occurring in all of the group companies. Thus the authorization of a financial group is the first step in the application of this new and more modern supervisory arrangement.
- 3.37 Annex 8 shows that the Super has received requests to authorize 18 groups, that 12 of these have been authorized. The others are pending further study. The resolutions of the Monetary Board approving these groups are also provided in the Annex. Thus the number of groups authorized exceeds the requirement of this condition by a wide margin.
- 3.38 **Article 4.04 (j)** That at least seven off shore banks, as defined by the law, have been: (i) qualified by the Superintendency of Banks to operate as such (ii) ordered to suspend activities in Guatemala or (iii) cited for operating in an illegal manner. **(complied)**
- 3.39 The control and supervision of offshore financial activity was a particularly important part of the reform because before it there was no information on the amount of banking activities that was occurring in these entities. What was known was that the offshores were a very large part of the overall financial system, that little was known of their activities and that abuses were probably occurring in some of them. As a result, the new legal framework includes provisions to bring these entities into regulation. It places strict controls on their activities to ensure that they are not taking on too many risks or engaging in suspicious activities, such as money laundering.
- 3.40 Now these entities are being regulated, supervised and inspected. Again, the first step in this process was to authorize or deny their operation in Guatemala. Annex 9 shows that applications have been received from 13 offshore banks. In consideration of their applications, the banks and their related onshore entities have been inspected in order to determine the scale of their activities, the amount of risks they were taking and whether these risks were adequately covered by capital and reserves. As a result of this process 11 offshore licenses have been approved and one offshore bank has been forced to suspend operations in

Guatemala. Approved resolutions are also provided in Annex 10 as well as a copy of the letter ordering one to suspend its activities.

- 3.41 **Article 4.04 (k)** That the accounting manual for banking operations have been prepared and approved by the Monetary Board. **(complied)**
- and
- 3.42 **Article 4.04 (l)** That all of the banks have adopted and are using the new accounting norms mentioned in paragraph (e) (iii) of Article 4.02 of these Special Conditions. **(complied)**
- 3.43 Previously banks in Guatemala were subjected to only local accounting norms. This caused problems because these norms tended to be more permissive than internationally accepted norms and because it made it difficult to compare the financial condition of a Guatemalan bank with banks in other countries, many of which had adopted either US GAAP or IAS standards. To solve these problems the new banking legislation mandated the adoption of the IAS standards. Resolution JM-48-2002 was issued to regulate the provision in the law regarding the new accounting standards. All banks are now following the new standards thus creating a discipline and standardization that did not exist before. Annex 10 contains copies of these regulations and other support material.
- 3.44 In order to facilitate the use of the new accounting standards Resolution JM-170-2003 mandated the adoption of a standard accounting manual. The manual has been drafted and formally approved and is in use.
- 3.45 **Article 4.04 (m)** That the register for external auditors of the Superintendency of Banks is functioning. **(complied)**
- 3.46 Resolutions JM-264-2002 requires all of the external auditors to be authorized by the Super before they can do audit work for financial institutions. Once they are authorized, they are included in the registry. Annex 11 provides the names, addresses and registration numbers of all of the external auditors that have been approved by the Super.

IV. Conclusion

- 4.1 The Administration of the Bank considers that the Borrower has complied fully with the conditions for the disbursement of the second tranche of Loan 1400/OC-GU established in Articles 4.04, paragraphs (a) through (m) with the exception of clauses (c) and (f). Clauses (c) and (f) have been substantially complied with, as described above in Section III. Accordingly, based on the evidence and information presented in Section III of this report, the Administration recommends that the Board of Executive Directors approve these waivers. If the Directors agree, the Administration will proceed with the disbursement of the resources of the second tranche of Loan 1400/OC-GU. The disbursement will be made after the period of notification to the Board of Executive Directors has passed, and no sooner than March 17, 2004 (ie after the 18 month minimum period for second disbursements of sector loans, has transpired), and in accordance with Document DR-398-4, Part III..

